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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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COMMISSIONERS
BOB STUMP - Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. E-01933A-12-0291 **STAFF'S OPENING BRIEF**

The Utilities Division Staff ("Staff") of the Arizona Corporation Commission ("Commission") hereby submits its post-hearing brief in support of the Settlement Agreement dated February 4, 2013, (as updated on March 1, 2013) ("Settlement Agreement" or "Agreement" or "S.A.").

I. INTRODUCTION.

On July 2, 2012, Tucson Electric Power Company ("TEP" or "Company") filed an application for an increase in its rates as well as for approval of (1) an updated rate design, (2) modifications to its Purchased Power and Fuel Adjustment Clause ("PPFAC"), (3) new or amended rate mechanisms, (4) an environmental compliance cost recovery mechanism and (5) modifications to its Tariff, Rules and Regulations and other existing compliance requirements.[1]

In its application, TEP requested a revenue increase in its non-fuel base rates of $127,760,000, including fuel and purchased power costs, or approximately 15.3 percent over adjusted test year retail revenues of $836,938,000, to be effective no later than August 1, 2013.[2] The requested revenue increase was based upon a 10.75 percent cost of equity with the Company's capital structure composed of 54 percent long-term debt and 46 percent common equity[3] using a December

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[1] Appl., Ex. TEP-7 at 1.
[2] *Id.* at 1, 5.
[3] *Id.* at 6.

31, 2011, test year.[4] TEP also requested the approval of two new rate mechanisms. The first request was for a lost fixed cost recovery ("LFCR") mechanism to address kWh sales lost as a result of the Commission's Renewable Energy Standard ("REST") Rules and Electric Energy Efficiency ("EE") rules.[5] The Company's second request was for an environmental compliance cost recovery mechanism intended to mitigate large future rate increases arising from changes in environmental regulations.[6] TEP also proposed a new method for determining demand side management and energy efficiency program costs recovered through its existing Demand Side Management Surcharge ("DSMS").[7]

TEP's proposed updated rate designs are intended to reduce customer confusion by simplifying its rate offerings, eliminating numerous "frozen" and other superfluous rates, and creating rates that would provide it with a better opportunity to recover its fixed costs and earn a reasonable return on its investment.[8]

A number of parties intervened in this proceeding including Arizonans for Electric Choice and Competition and Freeport McMorRan Copper & Gold, Inc. (collectively "AECC"), Arizona Investment Council ("AIC"), Arizona Public Service ("APS"), Arizona Solar Industries Association ("AriSEIA"), Department of Defense and all other Federal Executive Agencies ("DOD"), EnerNOC, Inc. ("EnerNOC"), IBEW Local 1116 ("IBEW"), the Kroger Co. ("Kroger"), Opower, Inc. ("Opower"), the Residential Utility Consumer Office ("RUCO"), Southern Arizona Homebuilder's Association ("SAHBA"), Southern Arizona Water Users Association ("SAWUA"), the Sierra Club ("Sierra Club"), the Solar Energy Industries Association ("SEIA"), Southwest Energy Efficiency Project ("SWEEP"), The Vote Solar Initiative ("VSI") and Cynthia Zwick ("Zwick"). On December 21, 2012, Staff, AECC, AIC, EnerNOC, IBEW, Kroger, Opower, RUCO, SAHBA, Sierra Club and SWEEP filed direct non-rate design testimony. Staff, AECC, DOD, Kroger, RUCO, SAWUA, SEIA,

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[4] Appl., Ex. TEP-7 at 2.
[5] *Id.* at 4.
[6] *Id.* at 5.
[7] *Id.*
[8] *Id.* at 4.

SWEEP, VSI and Zwick filed direct testimony regarding rate design and cost of service on January 11, 2013.

Staff made several recommendations pertaining to the Company's proposed rate base, expenses, revenues and net operating income resulting in a recommended revenue increase of no more than $76.406 million on adjusted fair value rate base ("FVRB").[9] Staff also recommended a capital structure, before adjustment for FVRB, of 43.50 percent common equity, 55.97 percent long-term debt and 0.53 percent short-term debt that were the same capital structure proportions for the subject test year ending December 31, 2011, reflected in the Company's Schedule D-1, page 1 of 2.[10] Staff also recommended a cost of equity of 9.4 percent, an overall cost of capital of 7.0 percent before adjustment for FVRB, a rate of return of 0.0 percent to 0.68 percent on the FVRB Increment,[11] and a fair value rate of return ("FVROR") range of 4.63 percent to 4.86 percent.[12] RUCO recommended a revenue increase of $26.781 million (3.07%).[13] AECC proposed a base rate increase of approximately $82.775 million or $44.525 million less than that sought by TEP[14] and a ROE of 10.1 percent.[15]

Staff further recommended adoption of the Company's proposed LFCR with the following modifications: (i) receive recovery for only distribution and transmission (delivery) service fixed costs; (ii) cap increased revenue allowed for each year at 1 percent; (iii) recover the lost fixed cost revenue on a percentage of revenue basis; and, (iv) make the LFCR mechanism effective beginning with the rate effective date for this case.[16] In addition, Staff recommended rejection of the Energy Efficiency Resource Plan ("EERP")[17] and Environmental Compliance Adjustor ("ECA")[18] as proposed by the Company. Further, Staff recommended adoption of the Company's proposed PPFAC with several modifications: (i) compliance with the Plan of Administration with respect to the

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[9] Smith Direct, Ex. S-1 at 5.
[10] Berry Direct, Ex. S-3 at 3.
[11] *Id.*
[12] *Id.*
[13] Mease Direct, Ex. RUCO-6 at 8.
[14] Higgins Direct, Ex. AECC-1 at 7-8.
[15] *Id.* at 36-37.
[16] Solganick Direct, Ex. S-11 at 4.
[17] McGarry Direct, Ex. S-9 at 11.
[18] *Id.* at 33.

reporting of fuel costs by plant; (ii) expansion of the required representation letter required by the Plan of Administration to include a statement that no Company interpretations of PPFAC includable costs or accounting adjustments were made to increase the PPFAC without full disclosure to and approval by the Commission; (iii) Company funding of performance/management audits as required by Staff; (iv) modification of the Plan of Administration to include proceeds from the sale of renewable energy credits ("RECs") that do not flow through the Renewable Energy Standards Tariff to customers; and, (v) modification of the Plan of Administration to incorporate the documentation recommendations from the Compliance Audit of the PPFAC conducted by the internal audit services.[19]

On January 8, 2013, TEP filed a notice of settlement discussions. The parties of record subsequently held settlement discussions beginning January 15, 2013. The settlement discussions were open, transparent, and inclusive of all parties to the Docket who desired to participate. All parties to the docket were notified of the settlement discussion process, were encouraged to participate in the negotiations, and were provided with an equal opportunity to participate.

The parties reached an agreement in principal and filed a preliminary settlement term sheet on January 22, 2013, reflecting the agreement terms. An Open Meeting was held on January 23, 2013, wherein the Commissioners offered input on the term sheet. On February 4, 2013, Staff filed a Notice of Filing Proposed Settlement Agreement. The Settlement Agreement was signed by Staff, TEP, RUCO, SAHBA, Kroger, AECC, EnerNOC, IBEW, AIC, Opower, SEIA, AriSEIA, VSI, DOD, SAWUA and Zwick (collectively, "Signatories"). SWEEP, Sierra Club and APS participated in settlement discussions but did not sign the Agreement.[20]

The purpose of the Settlement Agreement is to settle all issues presented by Docket No. E-01933A-12-0291 in a manner that will promote the public interest. The Signatories agree that the terms of the Agreement are just, reasonable, fair and in the public interest in that they, among other things, (i) establish just and reasonable rates for TEP's customers; (ii) promote the convenience,

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[19] Medine Direct, Ex. S-5 at 7.
[20] SWEEP filed testimony in partial opposition to the Settlement Agreement; Sierra Club joined in such opposition in part.

comfort, and safety, and the preservation of the health, of the employees and patrons of TEP; (iii) resolve the issues arising from this docket; and, (iv) avoid unnecessary litigation expense and delay.

II. BACKGROUND.

In 2008, TEP, Staff, AECC, DOD, AIC, IBEW, Kroger, and other parties entered into a Settlement Agreement ("2008 Agreement"), which was approved by the Commission in Decision No. 70628. Among the terms of the 2008 Settlement Agreement was a rate moratorium pursuant to which TEP's base rates would remain frozen through December 31, 2012. In its application, TEP asserted that since the Commission issued Decision No. 70628 on December 1, 2008, it has faced numerous financial challenges including flat retail kWh sales due to the economic downturn, increased distributed renewable energy and energy efficiency requirements, which further eroded its retail kWh sales, new environmental regulations, and increased capital investments and operating and maintenance costs.[21] TEP further asserted that, notwithstanding its adherence to the terms of the 2008 Agreement, it has been unable to earn a reasonable rate of return on a jurisdictional basis, its current rates are no longer just and reasonable and new, updated rates are needed to provide sufficient and predictable revenues in order to stabilize its financial health and provide it with access to the capital markets at reasonable rates.[22]

The settlement terms agreed to by the Signatories in this case balance the financial stability of TEP with benefits accorded its customers. These benefits include, among others:

- A limited first year bill impact for customers (less than $3.00 per month for a residential customer using the annual average of 767 kWh per month) despite the fact that TEP's current rates will have been in effect for almost 5 years at the time the new rates go into effect;
- A lower percentage rate impact on small commercial customers than the other customer classes;
- Continuing bill assistance for low income customers;
- A proposal that provides rate treatment for investments in energy efficiency in a manner similar to rate treatment for investments in other resources and that reduces the rate impact to the customer;

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[21] Appl., Ex. TEP-7 at 2.
[22] *Id.* at 3.

- An Environmental Compliance Adjustment ("ECA") mechanism that allows recovery, with a cap, of government-mandated environmental compliance costs in a manner that smoothes the rate impact of such compliance;
- A narrowly-tailored Lost Fixed Cost Recovery ("LFCR") mechanism that supports energy efficiency ("EE") and distributed generation ("DG") at any level or pace set by this Commission; and
- A fixed cost LFCR rate option for residential customers preferring to pay a specified charge for lost fixed costs rather than the variable LFCR.[23]

The Settlement Agreement is endorsed by sixteen of the eighteen parties to this proceeding, including Staff. Though non-signatories, SWEEP's and the Sierra Club's opposition to the Agreement is limited in scope: SWEEP and the Sierra Club oppose the LFCR and the significant increase in the residential monthly basic service charge.[24]

III. THE SETTLEMENT AGREEMENT IS IN THE PUBLIC INTEREST AND SHOULD BE ADOPTED BY THE COMMISSION.

A. The Proposed Settlement Agreement Resulted From A Transparent And Open Process And Represents Agreement Among A Diverse Group of Stakeholders.

It is never an easy task to get parties to a litigation to resolve their differences amicably, especially where the parties represent significantly divergent interests and positions. In this docket, eighteen parties engaged in open, transparent, and arm's length negotiations during an expedited three-week period in January and February 2013.[25] The diverse interests included Staff, RUCO, TEP, an investment counsel, consumer representatives, demand-side management ("DSM")/energy efficiency advocates, low-income consumer advocates, renewable energy advocates, labor unions, large/industrial users, competitive power producers and the mines.[26] That this number of

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[23] *See* Settlement Agreement ("S.A."), Ex. TEP-1 at 2-3.

[24] Schlegel S.A. Rsp., Ex. SWEEP-4 at 4:18-36; Sierra Club NOF (docketed 2-15-2013).

[25] Olea S.A. Direct, Ex. S-15 at 4 (Staff, TEP, RUCO, Freeport–McMoRan and AECC (collectively "AECC"), IBEW, Kroger, AIC, SWEEP, APS, EnerNOC, Opower, SAHBA, SAWUA, DOD, SEIA, AriSEIA, Sierra Club and Zwick); Hutchens S.A. Direct, Ex. TEP-2 at 6:8-7:6; Schlegel S.A. Direct, Ex. SWEEP-3 at 4:12-14.

[26] Olea S.A. Direct, Ex. S-15 at 4:12-5:2; Hutchens S.A. Direct, Ex. TEP-2 at 8:21-9:1; Quinn S.A. Direct, Ex. RUCO-1 at 3:16-20.

stakeholders was able to reach an accord during such a concentrated period is testament to their dedication, good faith efforts and cooperation.[27]

During negotiations, each participant was given a chance to advance the position of its respective client. Each of the signatories compromised on vastly different positions in order to reach agreement on all issues and further the public interest.[28]

B. Virtually All Parties Agree that The Proposed Settlement Agreement Is In The Public Interest.

The proposed Settlement Agreement comprehensively resolves all of the divergent issues raised in this proceeding and carefully balances the interests of ratepayers and shareholders. That the Settlement Agreement is in the public interest is echoed by all signatories. Most notably, Steve Olea, Utilities Director, testified that the compromises made by the Signatories in reaching the proposed Settlement Agreement further the public interest.[29] In addition, Mr. Olea stated that numerous provisions of the Settlement Agreement address the diverse interests of the Signatories, e.g., those promoting energy efficiency at any level or pace set by the Commission (Sections VII and VIII), the Environmental Compliance Adjustor surcharge (Section IX), Springerville Unit I (Section X), the TEP energy procurement program (Section XI), low-income customers (Section XII) Nogales Transmission Line (Section XIII), San Juan thermal event (fire) (Section XIV), quality of service (Section XVIII) and the four issues raised by RUCO (Section XX).[30]

Similarly, David Hutchens, TEP's president, testified that "the Settlement Agreement achieves a reasonable balance of the stakeholders' respective interests in TEP's rate case resulting in just and reasonable rates that are in the public interest."[31]

RUCO Director, Pat Quinn, noted that "[t]he fact that so many parties representing such varied interests were able to come together to reach consensus illustrates that balance, moderation

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[27] Quinn S.A. Direct, Ex. RUCO-1 at 11-14.
[28] Olea S.A. Direct, Ex. S-15 at 5:12, 22-24, 6:2-18, 18:13, 17-19:10, 20:19-22; Hutchens S.A. Direct, Ex. TEP-2 at 9:2-4; Quinn S.A. Direct, Ex. RUCO-1 at 6:19-7:9; Higgins S.A. Direct, Ex. AECC-3 at 2:9, 3:5-4:3.
[29] Ex. S-15 at 6:2-3.
[30] *Id.* at 6:10-18.
[31] Ex. TEP-2 at 1:19-21.

and compromise of the [Agreement] [and]... reflects an outcome that is fair to both the consumer and TEP and is in the public interest."[32]

Kevin Higgins, speaking on behalf of AECC and non-residential customers, testified that the Settlement Agreement produces just and reasonable rates, is in the public interest and provides benefits to customers.[33] Numbered among the customer benefits enumerated by Mr. Higgins are: (i) a level of base revenues that allows TEP a reasonable opportunity to earn a fair return on its investments; (ii) a reasonable rate of return and actual capital structure that equitably balances the interests of shareholders and customers, (iii) equitable dispersal of the overall base rate increase among customer classes; (iv) curing of a number of rate design problems enabling customers to continue to respond to good price signals, e.g., well designed time-of-use rates; (v) provision for a reasonable amortization period for recovery of EE investments and equitable mechanism for cost recovery; and (vi) provision of a narrowly tailored LFCR in lieu of full revenue decoupling which enables TEP to recover certain revenues deemed lost as a result of utility sponsored EE programs.[34]

While there was partial opposition to the proposed Agreement by two parties, that opposition was focused on the LFCR. Jeff Schlegel acknowledged that, notwithstanding the absence of a full revenue decoupling option, "on balance I believe the settlement agreement is in the public interest."[35]

C. The Proposed Settlement Agreement Was Designed To Give The Commission Maximum Flexibility With Regard to Policy Determinations.

The Commission has recently indicated a preference for addressing policy matters in generic dockets rather than in rate cases, thereby retaining more flexibility between rate cases. The proposed Settlement Agreement was intentionally structured to give the Commission the flexibility it seeks in making policy determinations. As pertains to the EERP, the Agreement provides the following at Section 7.9:

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[32] Quinn S.A. Direct, Ex. RUCO-1 at 4:11-14, 5:3-4.
[33] Tr. Vol. II at 246:15-16.
[34] Tr. Vol. II at 246:20 -252:25.
[35] Tr. Vol. III at 454, 457.

> Nothing in the Plan is intended to bind the Commission to any specific EE policy or standard, but merely sets up the method of recovery for investments to EE for any EE policy or standard established by the Commission.

The Signatories' intent to provide the Commission with maximum flexibility in setting EE and DG policy is further reiterated in Section 8.2 which states, in part, that: "Nothing in this Agreement is intended to bind the Commission to any specific EE or DG policy or standard."

D. The Agreement Appropriately Balances Ratepayer and Shareholder Interests.

The proposed Settlement Agreement has many provisions that will benefit consumers and TEP alike. Some of the more significant provisions are discussed below.

1. Limited first year bill year bill increase: less than $3.00 per month for residential ratepayers.

Pursuant to Paragraph 2.1 of the Settlement Agreement, the Signatories agreed to a $76.194 million increase which reflects a total non-fuel revenue requirement of $659,724,574, or an annual fuel increase of $31,599,730. Though approximately $52 million less than TEP requested, Company president, David Hutchens, noted that the Company can support this level of base rate increase due to the adjustor mechanisms (LFCR and ECA) that are included in the Settlement Agreement which will provide for recovery of some costs between rate cases, as well to "smooth out" the rate impact for [its] customers."[36]

As a result of the non-fuel base rate increase and the reduction in the PPFAC rate and DSMS, Paragraph 3.1 of the Settlement Agreement provides that, upon the effective date of the new rates, a residential customer using an annual average of 767 kWh per month will realize a first year monthly increase of less than $3.00.[37]

Based on the compromises resulting from the settlement negotiations, TEP agreed to the reduced non-fuel base rate increase and limited first-year bill impact for customers despite the fact that its current rates will have been in effect for almost five years at the time the new rates go into

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[36] Hutchens S.A. Direct, Ex. TEP-2 at 5:3-8, 8:11-19.

[37] Olea S.A. Direct, Ex. S-15 at 7:16-19; Hutchens S.A. Direct, Ex. TEP-2 at 5:2-3; Higgins S.A. Direct, Ex. AECC-3 at 7:3-5.

effect.[38] Contemporaneously, the increased non-fuel revenue, deemed as "critical" to TEP, will enable the Company to continue the positive momentum created by the 2008 Settlement Agreement and allow it to compete for, and attract, capital on favorable terms.[39] Moreover, AIC witness Gary Yaquinto commented that the fact that "this many years [after approval of the current rates in December 2008] the Settlement Agreement holds the average residential bill impact of the rate increase to under $3.00 in these circumstances is remarkable."[40]

2. Cost of capital.

Section IV sets forth the cost of capital agreed to by the Signatories. The Settlement Agreement adopts TEP's actual test year capital structure of 55.97 percent long-term debt, 0.53 short-term debt and 43.50 percent common equity, as initially recommended by Staff,[41] rather than TEP's hypothetical capital structure of 54 percent and 46 percent long-term debt and common equity, respectively, suggested in its Application.[42] AECC witness Kevin Higgins agreed with Staff witness Dr. Keith Berry and added that the Company's proposed hypothetical capital structure "unduly increased its revenue requirement[43] and that "use of the Company's actual capital structure in the Settlement Agreement is reasonable and is fair to both TEP and customers."[44] The Signatories have recommended a return on common equity of 10 percent, as initially proposed by RUCO, rather than TEP's suggested 10.75 percent, an embedded cost of long-term debt of 5.18 percent and cost of short-term debt of 1.42 percent. A fair value rate of return of 5.05 percent, which includes a 0.68 percent rate of return on the fair value increment of rate base, is also proposed by the Signatories. Higgins further submitted that the 10 percent ROE is "consistent with [the] fundamental relationships [espoused by AECC] and lies within the range of reasonableness."[45] Higgins added that the proposed

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[38] Olea S.A. Direct, Ex. S-15 at 18:19-22.
[39] Hutchens S.A. Direct, Ex. TEP-2 at 10:18-11:2.
[40] Yaquinto S.A. Direct, Ex. AIC-2 at 2:9-12.
[41] Berry Direct, Ex. S-3 at 3:2-5.
[42] *Id.* at 3:7-10.
[43] Higgins S.A. Direct, Ex. AECC-3 at 5:20-24.
[44] *Id.* at 6:3-5.
[45] *Id.* at 5:14-16.

0.68 percent on the fair value increment of rate base "is reasonable in light of the requirements of the Arizona constitution."[46]

As is evident from the above, the settlement negotiations engaged in served to reconcile the disparate positions initially espoused by various parties.

3. Continued assistance for low-income customers.

Section XII of the Settlement Agreement addresses programs specifically affecting low-income customers. In deference to the continued plight of customers who struggle to meet their monthly living expenses, the Signatories agreed to certain provisions to aid such low-income ratepayers. Pursuant to Paragraph 12.1, the monthly bill of a Lifeline customer will be limited to an increase that is generally reflective of the average monthly dollar increase of a standard R-01 customer, i.e., less than $3.00.[47] In addition, Paragraph 12.2 provides that the PPFAC rate and DSM surcharge shall now apply to Lifeline customers and currently frozen rates shall no longer be portable. Further, the Signatories agreed, pursuant to Paragraph 12.3, that the Life Fund established by the Commission in Decision No. 59594 should be eliminated and, in its place, TEP will make an annual contribution of $150,000 to fund the low income utility bill assistance program beginning September 1, 2013.[48]

4. Purchased power and fuel adjustment clause ("PPFAC").

The current PPFAC established in Decision No. 70628 will continue to collect or refund to customers actual costs of fuel and purchased power that are above or below the amount included in base rates.[49] Decision No. 70628 also requires TEP to reset its PPFAC rate annually on April 1 of each year.[50] Paragraph 6.1 of the Settlement Agreement resets the average retail base fuel rate of the PPFAC at $0.032335 per kWh. However, in light of the one-time $3 million credit related to previous sulfur credits and the deferral of $9.7 million of costs related to the San Juan thermal event

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[46] Higgins S.A. Direct, Ex. AECC-2 at 5:16-19.
[47] Olea S.A. Direct, Ex. S-15 at 14:9-10; Hutchens S.A. Direct, Ex. TEP-2 at 9:8-10; Yaquinto S.A. Direct, Ex. AIC-2 at 18-19.
[48] Ex. S-15 at 14:2-7.
[49] Ex. TEP-2 at 11:18-20.
[50] Ex. S-15, at 9:2-3.

(addressed in Section XIV of the Settlement Agreement), on the effective date of the new rates the PPFAC will be set as a credit to customers of $0.001388 per kWh.[51] In addition, the Signatories agreed that the PPFAC Plan of Administration will be modified to allow TEP to recover the following costs and/or credits: brokers' fees, lime costs, sulfur credits and 100 percent proceeds from the sale of SO_2 allowances.[52]

TEP has also filed a request to defer implementation of the referenced PPFAC's rate reset until the effective date of the decision in this case. The Signatories believe that, in order to offset the current rate increase and avoid a yo-yo effect and customer confusion, such deferral is in the public interest.[53] As Staff has asserted, deferral of the PPFAC reset, which would be a decrease, is a way to smooth out some of the rate impact to customers that would take place when TEP's rate increase occurs, hopefully on July 1, 2013.

5. Energy efficiency resource plan ("EERP").

Section VII of the Settlement Agreement intends to implement an EERP as proposed by Staff in its Direct Testimony which is intended to treat energy efficiency programs as any other generation resource.[54] Under the EERP, TEP will invest its own capital in cost-effective EE measures that have been approved by the Commission.[55] Once TEP provides documentation that the EE programs have been effective, the Company will be given the opportunity to recover the cost of its EE investment, including a rate of return based on its approved Weighted Average Cost of Capital ("WACC") as established herein, but not a performance incentive, through its DSM adjustor mechanism.[56] However, in the event the Company's EE investments do not provide results above the minimum expected energy savings and below a targeted price per kWh, TEP will be unable to recover its EE/DSM program related costs.[57]

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[51] Olea S.A. Direct, Ex. S-15 at 8:9-14; Ex. TEP-2 at 12:1-5.
[52] Hutchens S.A. Direct, Ex. S-15 at 8:15-18; Ex. TEP-2 at 11:20-22.
[53] Ex. S-15 at 9:3-6; TEP-2 at 12:5-8; Tr. Vol. I at 192.
[54] Ex. S-15 at 9:9-11, 10:1-2.
[55] *Id.* at 9:11-13.
[56] Ex. S-15 at 10:2-5; Ex. TEP-2 at 14:25-27, 15:5-11.
[57] Ex. TEP-2 at 16:2-5.

Under the proposed EERP agreed to by the Signatories, TEP will: amortize its annual EE investments over five years, resume funding of EE programs previously approved by the Commission beginning March 1, 2013, and request recovery of such costs through the plan, upon the effective date of the rates in this docket, begin investing in cost-effective DSM/EE programs pursuant to the Plan for the remainder of 2013, which includes programs and the annual budget recommended by Staff for TEP's 2011-12 EE Implementation Plan filed in Docket No. E-01933A-11-0055 and request closure of Docket No. E-01933A-11-0055 in this case upon approval of the Plan.[58]

The EERP further provides that any customer who can demonstrate an active DSM program and whose single site usage is 25 MW or greater may petition the Commission for an exemption from the DSM adjustor.[59] The Plan also provides that the DSM surcharge be assessed on a per kWh basis for residential customers and a percentage of bill basis for non-residential customers.[60] The current DSM surcharge for residential customers will be reset from $0.001249 to $0.000443 per kWh upon the effective date of the new rates in this case.[61]

The Signatories and, particularly, Staff and TEP, believe that energy efficiency is one of the cheapest resources and that it is in the public interest to treat investments in such programs similar to other typical generation resources.[62] Moreover, as before stated, it is imperative to note as stated in Paragraph 7.9 of the Settlement Agreement, that the proposed EERP is intended to provide a mechanism for TEP to recover its EE costs and in no way would limit the Commission's authority to decide what it wants to do with EE and EE rules.

6. The LFCR.

The Signatories all testified in support of energy efficiency as a low cost energy resource. Because the Commission rules cause utilities to sell fewer kWh, utilities such as TEP do not have the opportunity to recover the portion of the fixed cost of service embedded in its volumetric rates. TEP witness, David Hutchens, testified that TEP is unable to recover the fixed distribution and

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[58] Olea S.A. Direct, Ex. S-15 at 10:1-19.
[59] *Id.* at 10:21-26.
[60] *Id.* at 11:1-5.
[61] *Id.*
[62] *Id.* at 11:9-11; Hutchens S.A. Direct, Ex. TEP-2 at 15:14-15.

transmission costs that are embedded in its volumetric rates.[63] As set forth in Section XIII of the Agreement, the adoption of the LFCR mechanism (which includes a residential fixed monthly rate option), will provide TEP with the opportunity to recover a portion of its fixed cost of service and receive possible relief from the financial impact of verified lost kWh sales attributed to Commission requirements regarding energy efficiency and distributed generation. The Agreement also provides for a detailed Plan of Administration. Moreover, residential customers who do not want to be charged the standard LFCR variable rate charge based on kWh usage will have the option of choosing a fixed, monthly LFCR charge.[64] TEP will implement an extensive customer education and outreach program commencing in 2014 to help customers understand the new LFCR and available options. Certain large customers are excluded because the rate design for those customers ensures that they pay their fair share through the monthly minimum.

7. Environmental compliance adjustor.

In its application, TEP requested an Environmental Compliance Adjustor to "provide more timely recovery of substantial upcoming capital expenditures necessary to meet several new government mandated regulations."[65] In deference to such anticipated extensive costs, the Signatories have agreed to implement an ECA aimed at recovering costs incurred by TEP to meet these governmentally mandated environmental controls imposed and/or expected to be imposed by the Environmental Protection Agency ("EPA") and other governmental agencies between rate cases. Section IX provides for the recovery of and return on capital investments and associated costs related to environmental investments made by TEP and not already recovered in base rates approved in this case or recovered through another Commission-approved mechanism.[66] TEP must demonstrate that each environmental control for which it seeks cost recovery is government mandated and was a reasonable and prudent option available at the time.[67] TEP's ECA cost recovery is subject to a cap equal to 0.25 percent of total TEP retail revenue.

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[63] Hutchens S.A. Direct, Ex. TEP-2 at 14.
[64] Ex. TEP-2 at 14.
[65] Appl., Ex. TEP-7 at 10.
[66] Olea S.A. Direct, Ex. S-15 at 12:19-23.
[67] *Id.* at 12:25-13:1.

Implementation of the ECA benefits both customers and the Company. Customers are protected from large rate increases due to the 0.25 percent cap and, potentially, will be subject to lower financing costs charged to TEP.[68] Tangentially, customers will be the beneficiaries of enhanced environmental protections. Contemporaneously, the ECA will provide TEP with increased cash flow to aid in its timely recover of the costs of such governmentally mandated environmental controls between rate cases which, in turn, may support credit quality. AIC's Yaquinto added that it "is an acceptable way to afford more timely recovery on these investments over which TEP has little-to-no-control. It is credit supportive and will be viewed as such by the markets."[69] AECC's Higgins commented that, contrary to the open-ended ECA initially proposed by TEP, the Settlement Agreement's 0.25 percent cap provides the ratepayer protection necessary to gain AECC's acceptance of this provision.[70]

8. Other important settlement provisions.

a. Springerville Generating Station.

Currently, TEP is leasing Springerville Generating Station ("SGS") Unit 1; the lease is set to expire in January 2015.[71] In order to ensure that the Commission obtain timely information on the status of SGS Unit 1 and to ensure that TEP has explored all options available to it when considering either to extend the lease, build a new generation resource, enter into a Purchase Power Agreement ("PPA") or other option, the Signatories agree that TEP will provide the following information to the Commission no later than July 31, 2014:

- Commitments made by TEP to purchase SGS Unit 1 or any agreement entered into by TEP to otherwise retain capacity rights to SGS Unit 1.
- Commitments made by TEP to purchase replacement generating resource, or any PPA entered into by TEP for replacement power.
- Commitments made by TEP to purchase the SGS Coal Handling Facilities or any agreement entered into by TEP to extend the Coal Handling Facilities lease.

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[68] Yaquinto S.A. Direct, Ex. AIC-2 at 3:1-5.
[69] *Id.* at 2:19-21.
[70] Higgins S.A. Direct, Ex. AECC-3 at 11:5-8.
[71] Olea S.A. Direct, Ex. S-15 at 13:4-6.

- Estimated non-fuel revenue requirement associated with each commitment listed above, including the proposed rate treatment of any remaining balance of SGS leasehold improvements.

The timing of this report and the type of information required to be submitted by TEP is intended to allow Staff and other interested parties to review TEP's proposal and bring this matter to the Commission's attention before the leases expire in January 2015.

b. Rate design.

Section XV of the Settlement Agreement addresses TEP's rather complex rate design and begins the process of simplifying and modernizing the Company's rate offerings.[72] Currently, TEP customers have a myriad of rates to choose from with the resulting costs to administer. The Company proposed the consolidation of a number of rates to reduce customer confusion and costs. The Settlement Agreement implements many of Signatories' rate design concepts and provides substantial movement in modernizing the Company's rate design.[73] The highlights of the agreed-upon rate design include consolidating and simplifying the Company's rate offerings to more closely align the schedules with its CCOSS while incorporating many other important rate design factors. The one exception is that the Settlement Agreement retains the numerous frozen low-income rate tariffs for the reasons described above.

The rate design also simplifies the Company's time of use ("TOU") offerings in a way that will make them less confusing. The changes include: (i) making the peak times consistent across all classes in recognition that the actual peak times on TEP's system do not vary by class; (ii) eliminating the shoulder period for all non-frozen TOU rate classes; and (iii) reducing the length of the peak period to provide for greater opportunity for customer participation.[74]

The rate schedules for those large customers with demand charges are adjusted by the adjustment of the demand charges to better reflect the cost to serve, modification of the "ratchet" to be consistent across these classes, and the adjustment of the per-kWh or "energy" charge for these customers, which in some instances included a decrease.[75]

[72] *See* Solganick S.A. Direct, Ex. S-14 at 5-7; Dukes S.A. Direct, Ex. TEP-4 at 6.
[73] Ex. S-14 at 5-7.
[74] *See* Ex. S-14 at 7; Ex. TEP-4 at 6.
[75] Ex. TEP-4 at 6-7.

Acknowledging that the substantial consolidation and simplification of rates may have unintended consequences, the Signatories agreed to leave the docket open until July 1, 2014 for the express purpose of possibly adjusting specific tariffs to correct for unanticipated customer impacts, which are not consistent with the public interest.

c. Additional settlement provisions.

Section XX includes provisions to address a variety of issues that arose during the course of the settlement discussions. Paragraph 20.1 is intended to require TEP to propose a similar treatment of the retail space in TEP's headquarters building in the next TEP general rate case. This provision is not intended, however, to bind the Commission to that treatment in the next rate case.

Paragraph 20.2 requires TEP to request the opening of a generic docket to address the appropriate treatment of Net Operating Losses in rate cases. This issue may arise more frequently as a result of increased bonus depreciation opportunities and guidance from the Commission would assist the parties in future rate cases.

Paragraph 20.3 addresses RUCO's concern about TEP's depreciation reserves.

Paragraph 20.4 provides a process for addressing RUCO's concerns about distribution plant. Staff did review TEP's plant and found that it was used and useful.[76] However, this process will provide an on-going dialog with RUCO and Staff about future capital expenditure, particularly on distribution plant. Over the next three years, TEP will meet with Staff and RUCO in the fourth quarter of each year to review its capital expenditure plans.[77]

Paragraph 20.5 requires TEP to file a proposed tariff for interruptible rates by August 30, 2013, and for Staff to file a Staff Report and Proposed Order for Commission consideration by December 31, 2013.

Paragraph 20.6 addresses a request from AECC to consider a rate for very large customers. TEP has agreed to propose such a new rate in its next rate case.

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[76] Hutchens S.A. Direct, Ex. TEP-2 at 23:25-27.

[77] Tr. Vol. I at 98:6-25.

IV. RESPONSE TO SWEEP'S AND SIERRA CLUB'S PARTIAL OPPOSITION TO THE PROPOSED SETTLEMENT AGREEMENT.

Despite the many benefits presented by the proposed Settlement Agreement, SWEEP and Sierra Club have expressed limited disagreement with it. Although both SWEEP and Sierra Club characterize their positions as "partial" opposition, it is important to recognize that the proposed Settlement Agreement is a global resolution of issues that were in dispute between the signing parties. Provisions within the proposed Settlement Agreement state that rejection of any component of the proposed Settlement Agreement by the Commission may be deemed a material change by a Signatory.[78] In that event, the party would not be bound to support the Settlement Agreement and all Signatories, except Staff, would be obliged to support that party in requesting a rehearing to reinstate the provision.[79] In light of several Signatories' expressed interest in rejecting the modifications that SWEEP and Sierra Club have proposed, SWEEP's and Sierra Club's characterization of their positions as "partial" opposition understates the significance of the changes they advocate.[80] Against the backdrop of SWEEP and Sierra Club's failure to provide specifics to detail how the modifications would be implemented, it is clear that SWEEP's and Sierra Club's modifications should be rejected.

The principal disagreement SWEEP and Sierra Club have with the proposed Settlement Agreement relates to the LFCR mechanism and how it does not completely sever the relationship of volumetric sales to fixed cost recovery.[81] As they contend, retaining this connection perpetuates the utility's disincentive to wholeheartedly encourage measures that reduce ratepayer consumption. Additionally, SWEEP and Sierra Club express disagreement with the rate design adjustment to marginally increase the customer charge.[82] Finally, SWEEP suggests that the proposed Settlement Agreement effectively limits the Commission's policymaking authority by precluding an alternative to the LFCR that would not jeopardize the proposed Settlement Agreement.[83]

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[78] S.A., Ex. TEP-1 at ¶21.5.
[79] *Id.*
[80] Tr. Vol. III at 432:7 – 23; Schlegel S.A. Direct, Ex. SWEEP-3 at 4; Sierra Club NOF (docketed 2-15-2013).
[81] Ex. SWEEP-3 at 13-15; Sierra Club NOF 2-15-2013.
[82] *Id.*
[83] Tr. Vol. III at 459:1 – 14; Schlegel S.A. Direct, Ex. SWEEP-3 at 13:32 - 39.

A. The LFCR Is Preferable To Full Revenue Decoupling In The Context Of This Case.

Both Sierra Club and SWEEP advocate for the substitution of full revenue decoupling instead of implementing an LFCR mechanism.[84] SWEEP[85] asserts that full revenue decoupling presents advantages over an LFCR including elimination of a utility's disincentive to engage in energy efficiency,[86] production of a credit to ratepayers under certain circumstances,[87] and elimination of a utility's disincentives to support activities that reduce sales but are not directly linked to the utility's portfolio of energy efficiency programs.[88]

In the original application the Company proposed an LFCR mechanism that Staff evaluated. Based on its analysis, Staff determined that an LFCR would be an appropriate measure for TEP with some modifications that have been adopted in the proposed Settlement Agreement. The LFCR is responsive to the impacts on the Company due to energy efficiency and distributed generation and is directed at only narrowly defined fixed costs that TEP actually loses rather than all of the Company's non-variable costs.

1. The LFCR is narrowly crafted and in the public interest.

SWEEP contends that the LFCR deprives customers of benefits presented by full decoupling, such as the availability of a credit under circumstances where weather and economic conditions increase volumetric sales.[89] In response, Staff witness Howard Solganick identified a number of characteristics of full decoupling that are absent with the LFCR mechanism.

The first issue that Mr. Solganick identified was the susceptibility of full revenue decoupling to "pancaking" increases under certain circumstances.[90] As explained by Mr. Solganick, a season of mild weather, producing reduced demand for electric utility service, would generate a surcharge

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[84] Tr. Vol. III at 432:13 – 16; Ex. SWEEP-3 at 13-14; Sierra Club NOF (docketed 2-15-2013).
[85] Per the NOF docketed on 2-15-2013, Sierra Club adopted the position of SWEEP with regard to the LFCR mechanism but did not supply testimony responsive to the proposed Settlement Agreement.
[86] Ex. SWEEP-3 at 14:3 – 9.
[87] *Id.*
[88] *Id.*
[89] Ex. SWEEP-3 at 14.
[90] Solganick S.A. Direct, Ex. S-14 at 16-17; Tr. Vol. III at 501:18 – 502:6.

under full decoupling. If the following period had adverse weather customers would be paying higher bills for both their increased weather driven consumption and for the surcharge from the previous period due to the mild weather.[91] Consequently, the same weather event could generate multiple rate increases for the ratepayer.[92]

Additionally, as Mr. Solganick explained at hearing, full decoupling can give rise to scenarios where a utility perversely benefits from prolonged outage events. As Mr. Solganick explained:

> Unless decoupling is carefully constructed, the utility's gross sales could drop because of a major outage. All right? And it is all in the calculation that we are entitled to so many cents per, so many dollars per customer. And as I said a year ago, decoupling, unless it has an outage exemption in it, becomes a cash register for the utility during the outage. While the sales drop, at some point they are going to get some benefit back from decoupling. I don't think most utilities want to be in that position. That's just adding injury to insult after a major outage.[93]

The final issue is the perennial concern with how full decoupling affects the risks a utility faces. As multiple witnesses have recognized, it is common to incorporate a cost of equity adjustment to reflect the risk-alleviating quality of full revenue decoupling.[94] In the recent rate decision for Southwest Gas Company, the full revenue decoupling alternative presented to the Commission incorporated an adjustment to reduce the return on equity if the Commission selected full decoupling.[95] Determining an appropriate return on equity is frequently one of the most contentious issues presented in a rate case, and determining what the adjustment should be, as well as whether to implement one in conjunction with full decoupling, or after the implementation of full decoupling, is an issue that will not be resolved by simple substitution of a full revenue decoupling mechanism for the LFCR.[96]

2. Avoids having to delay proceedings due to an insufficient record to support decoupling.

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[91] Tr. Vol. III at 501-502.
[92] *Id.* at 501:18 – 502:6.
[93] *Id.* at 502:9-26.
[94] *Id.* 273:5 – 16, 330:16 - 331:3, 461:8 - 462:11.
[95] Decision No. 72723, Docket No. G-01551A-10-0458.
[96] *See e.g.* Tr. Vol. II at 330:16-331:3 (Dukes), 460:21-463:13 (Schlegel), 496:19-498:9 (Solganick).

As Mr. Solganick observed, the issues he identifies with decoupling generally can be remedied with foresight and appropriate checks built into the decoupling mechanism insofar as those issues involve "the devil in the details."[97] Unfortunately, the record in this matter does not contain sufficient detail to craft reasonable measures to alleviate such issues. Moreover, the parties advancing the full revenue decoupling position have failed to supply evidence on the record sufficient to implement any decoupler, much less one with reasonable provisions to alleviate the potential for unintended negative impacts.

Mr. Solganick noted that the incentive to the prolonged outages issue he identified may be dealt with using appropriate regulatory devices to prevent its occurrence.[98] Likewise, one virtue of the LFCR is the cap on increases, which also may be applied to a decoupling mechanism.[99] Similarly, to the extent that full revenue decoupling shifts weather and economic risks from the shareholder onto the ratepayer, adjustments to the return on equity are available to account for that impact.[100]

Unfortunately, as was conceded by Mr. Schlegel, no party to this matter has developed an appropriate record to support the institution of full revenue decoupling in conjunction with reasonable measures to account for these concerns.[101] SWEEP acknowledges that it could have supplied the requisite detail in its case for full revenue decoupling.[102] Instead, SWEEP opted to oppose the LFCR, which SWEEP freely admits is better than maintaining the status quo,[103] without creating a record that would support adoption of full revenue decoupling. In SWEEP's view, a full revenue decoupling mechanism would have to be developed primarily by the Company but with input from all parties.[104]

The Commission already has a proposal before it that was developed by the Company in conjunction with input from all the parties. SWEEP has acknowledged that parties may view

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[97] Tr. Vol. II at 501:15-16.
[98] *Id.* at 502:21 – 503:1.
[99] *Id.* at 478:9 – 479:1.
[100] *Id.* at 330:16-331:3, 460:21-463:13, 496:19-498:9.
[101] *Id.* at 459:16 - 460:1.
[102] *Id.* at 460:2 - 16.
[103] *Id.* at 458:3 - 16.
[104] Tr. Vol. II at 460:16 - 18.

rejection of the LFCR in favor of full revenue decoupling as a material change to the proposed Settlement Agreement, thereby jeopardizing all other areas of agreement presented by the Settlement.[105] In light of the amount of effort applied toward crafting a global settlement of issues, the availability of a thoroughly discussed LFCR mechanism that all parties acknowledge is an improvement for the Company, and the lack of a sufficiently detailed alternative proffered by opponents to the LFCR, Staff recommends that the Commission decline SWEEP's invitation to set aside the LFCR for an as yet undeveloped full revenue decoupling mechanism.

B. Adjusting The Customer Charge Is Appropriate Rate Design.

SWEEP and Sierra Club also take issue with the adjustment to the basic service charge for residential ratepayers.[106] The proposed Settlement Agreement increases the residential customer basic service charge $3.00 for Residential R-01 customers.[107] SWEEP and Sierra Club express concern that "this charge is one that customers cannot mitigate or reduce through their actions."[108] Further, SWEEP and Sierra Club have protested the extent of the increase in the residential customer charge, contending that it is not consistent with principles of gradualism.[109]

SWEEP's concern that the basic service charge is increasing as much as 40 percent demonstrates a misunderstanding of the issue of gradualism. As was explained by TEP witness Dallas Dukes, gradualism is not a concern in the absence of a rate shock issue.[110] As suggested by the sample bill impact produced by TEP for the average customer on Residential R-01, a customer with average usage will see an overall bill increase of less than four percent.[111] In light of the modest degree of total bill increase, there is no rate shock issue presented in this case. Consequently, gradualism is not a concern presented by the proposed Settlement Agreement's adjustments to the basic service charge.

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[105] *Id.* at 459:4 – 8.
[106] Schlegel S.A. Direct, Ex. SWEEP-3 at 14.
[107] *See e.g.* Sample Bill Impact, Ex. TEP-8.
[108] Ex. SWEEP-3 at 15:27 - 28.
[109] *Id.* at 15:14 – 18.
[110] Tr. Vol. II at 316:1 – 317:2.
[111] Sample Bill Impact, Ex. TEP-8.

SWEEP's and Sierra Club's concerns relating to the allocation of fixed cost recovery through the basic service charge are likewise misguided. SWEEP argues that increasing the basic service charge mutes the price signal to ratepayers to reduce usage and that higher basic service charges fall disproportionately on low income ratepayers. Both TEP witnesses Hutchens and Dukes provided ample testimony to the effect that, even with the slight increase in the basic service charge, a substantial percentage of the Company's fixed costs remain tied to volumetric sales.[112] As Mr. Dukes illustrated using a residential customer with average usage, only $10 of an average $85 bill is a fixed charge with all other parts varying by customer usage.[113] Clearly, ratepayers will retain a significant opportunity to save on their electric bills by engaging in energy efficiency.

With respect to SWEEP's concerns relating to low income ratepayers, the proposed Settlement Agreement increases the amount of low income ratepayer discount from $8 to $9.[114] Additionally, two ratepayer advocates participated in the settlement discussions and are signatories to the proposed Settlement Agreement, RUCO and Ms. Cynthia Zwick. RUCO noted the modest total increase in rates and the provisions for low income ratepayers as benefits to the proposed Settlement Agreement.[115]

Ms. Zwick testified in support of the proposed Settlement Agreement and enumerated several benefits directly impacting low income ratepayers, including TEP's annual contribution of $150,000 to Arizona Community Action Association to fund low income ratepayer bill assistance programs.[116] The contribution is a substantial increase in the amount of funding assistance from the prior arrangement whereby only the interest on a Company shareholder funded account was being applied toward low income bill assistance.[117]

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[112] Hutchens S.A. Rsp., Ex. TEP-3 at 6:13 – 16; Tr. Vol. II at 317:2 – 319:10.
[113] Tr. Vol. II at 319:3 – 10.
[114] Tr. Vol. III at 407:12 – 21.
[115] Quinn S.A. Direct, Ex. RUCO-1 at 6:10 – 11.
[116] Zwick S.A. Direct, Ex. Zwick-2 at 2 – 3; Tr. Vol. III at 409:8 – 410:20.
[117] Tr. Vol. I at 159:5 – 16.

In light of the ratepayer advocates' support for the proposed Settlement Agreement, SWEEP's and Sierra Club's concerns regarding the slight increase to the residential basic service charge are not supported by the record and should be rejected.

V. THE LEGAL AUTHORITY OF THE COMMISSION TO ESTABLISH ADJUSTOR MECHANISMS.

The Settlement Agreement proposes several adjustors, the LFCR, the ECA, the DSMS and the PPFAC. Any discussion of the constitutionality of adjustor mechanisms should start with an examination of the Commission's ratemaking authority.

A. The Setting of Just And Reasonable Rates.

1. The Commission's constitutional ratemaking authority and fair value.

Article 15, Section 3 of the Arizona Constitution provides, in relevant part, that the Commission "shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected by public service corporations within the State for service rendered therein. . . ." In determining just and reasonable rates, the Commission has broad discretion, subject to the obligation to ascertain the fair value of the utility's property and to establish rates that "meet the overall operating costs of the utility and produce a reasonable rate of return."[118] Under the Arizona Constitution, a utility company is entitled to a fair rate of return on the fair value of its properties, "no more and no less."[119] Arizona law does not mandate that the Commission (1) follow a particular method in its rate making determinations or (2) exclude consideration of relevant factors.[120] The Commission's ratemaking authority involves more than merely determining rates and indeed extends to every necessary step in ratemaking.[121]

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[118] *Scates v. Arizona Corp. Comm'n,* 118 Ariz. 531, 534, 578 P.2d 615 (App.1978).

[119] *Litchfield Park Service Co. v. Arizona Corp. Comm'n,* 178 Ariz.431, 434, 874 P.2d 988, 991 (App.1994) (citing *Arizona Corp. Comm'n v. Citizens Utilities Co.,*120 Ariz. 184, 190 n.5, 584, P.2d 1175, 1181 n.5 (App.1978).

[120] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

[121] *Arizona Corp. Comm'n v. State ex rel. Woods,* 171 Ariz. 286, 294, 830 P.2d 807, 815 (1992).

Article 15, Section 14 of the Arizona Constitution provides that: "The corporation commission shall, to aid it in the proper discharge of its duties, ascertain the fair value of the property within the state of every public service corporation doing business therein…." The court in construing these provisions of the constitution said:

> In order that the Corporation Commission might act intelligently, justly, and fairly between the public service corporations doing business in the state and the general public, section 14 was written into the Constitution. The 'fair value of the property' of public service corporations is the recognized basis upon which rates and charges for services rendered should be made, and it is made the duty of the Commission to ascertain such value, not for legislative use, but for its own use, in arriving at just and reasonable rates and charges, and to that end the public service corporations are required to furnish the Commission all the assistance in their power.[122]

Thus, the two constitutional provisions have been interpreted as requiring the Commission to find the "fair value" of the utility's property and use that as a rate base in calculating just and reasonable rates.[123] The purpose of the fair value requirement is to provide a fair return on the fair value of the property that a utility devotes to public use.[124]

Subsequent Arizona decisions have followed *Simms* in affirming that fair value is the exclusive means of determining a utility's rate base.[125] However, the court in *U.S. West Communications v. Arizona Corp. Comm'n*, ("U.S. West II") stated that, while the constitution plainly required the Commission to ascertain fair value, only the jurisprudence of the courts required that the Commission establish rates based on fair value finding.[126]

Despite the requirement that the "fair value" of a utility's property be found and used in setting rates (at least in a monopolistic setting),[127] the Commission nevertheless has substantial

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[122] *State v. Tucson Gas, Electric Light & Power Co.*, 15 Ariz. 294, 301, 138 P. 781, 784 (1914).
[123] *Simms,* 80 Ariz. at 751, 294 P.2d at 382.
[124] *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959).
[125] See *Consolidated Water Utilities, Ltd. v. Ariz. Corp. Comm'n* 178 Ariz. 478, 875 P.2d 137 (App. 1993); *Ariz. Corp. Comm'n v. Arizona Water Co.* 85 Ariz. 198, 335 P.2d 412 (1959).
[126] 201 Ariz. 242, 245-46, 34 P.3d 351, 354-55 (2001).
[127] U.S. West at 246, 34 P.3d at 355. The court noted: where a fair value finding that there is no need to rigidly link the fair value determination to the establishment of rates in a competitive environment. While the Commission cannot ignore fair value, in a competitive environment it can be used in conjunction with other information and given the proper weight at the Commission's discretion. See also *Phelps Dodge Corp. v. Arizona Corp. Comm'n*, 207 Ariz. 95, 83 P.3d 573 (2004), quoting *U.S. West II.*

discretion to adopt methodologies and approaches to address particular problems, such as significant capital investment and additional operating expenses. As the Arizona Supreme Court explained:

> "The Corporation Commission in its discretion can adopt any of the various approaches used by public utility regulative bodies in considering plant under construction as long as the method complies with the constitutional mandate [of finding fair value] and is not arbitrary and unreasonable."[128]

In *Arizona Public Service*, the Commission in a special action appealed a superior court decision which vacated an order of the Commission in a rate-making proceeding. In that case, the court criticized an opinion issued by the Arizona Attorney General stating that the Commission may not consider plant under construction at the close of the historic test year, in setting rates. In rejecting that opinion, the court stated:

> From the foregoing, it is obvious that the Commission in its discretion can consider matters subsequent to the historic year, bearing in mind that all parties are entitled to a reasonable opportunity to rebut evidence presented... We would not presume to instruct the Commission as to how it should exercise its legislative functions. . . . However, it appears to be in the public interest to have stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings.[129]

In a subsequent decision involving Arizona Public Service Co. ("APS"), *Arizona Cmty. Action Ass'n* v. *Arizona Corp. Comm'n,*[130] the court addressed "step increases." The Commission had granted APS a six percent rate increase in August 1977, which took effect immediately. In addition, APS was authorized to increase its rates in 1978 and again in 1979, provided that certain conditions were satisfied.[131] Under the Commission's decision, if the return on APS' common stock fell below 13.75 percent, APS was entitled to increase its rates by an amount equal to five percent of its gross operating revenue or by a "revenue deficiency," whichever is less.

On appeal, the Arizona Supreme Court quoted extensively from its previous *Arizona Public Service* decision, again emphasizing that the Commission may consider plant under construction and

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[128] *Arizona Corp. Comm'n* v. *Arizona Pub. Serv.,* 113 Ariz. 368, 371, 555 P.2d 326, 329 (1976).
[129] *Arizona Pub. Serv.,* 113 Ariz. at 371, 555 P.2d at 329 (citations omitted).
[130] *Arizona Cmty. Action Ass'n* v. *Arizona Corp. Comm'n,* 123 Ariz. 228, 559 P.2d 184 (1979).
[131] Arizona Cmty. Action Ass'n at 229, 599 P.2d at 185.

placed in service at a future date in determining a utility's "fair value" rate base.[132] The court then discussed the step increases authorized by the Commission, holding that this methodology comported with the Commission's constitutional requirements and noting that the Commission had established fair value:

> In view of *Arizona Corporation Commission v. Arizona Public Service, supra,* we find entirely reasonable that portion of the Commission's decision allowing the inclusion of construction work in progress to go on line within two years from the effective date of the Step II increase. Nor do we find fault with the Commission's attempt to comply with our indication in *Arizona Corporation Commission v. Arizona Public Service, supra,* that a constant series of extended rate hearings are not necessary to protect the public interest. The hearing culminating in the order of August 1, 1977, resulted in a determination of fair value. The adjustments ordered by the Commission in adding the CWIP to that determination of fair value were adequate to maintain a reasonable compliance with the constitutional requirements if used only for a limited period of time. Adjustments would obviously be made after a full hearing [using] a test year ending December 31, 1978, as provided in the contested order.[133]

Also instructive is *Scates.*[134] In that case, the utility was granted increases in its statewide charges for the installation, moving and changing of telephones, which amounted to an annual increase in revenues of nearly $5 million. In approving this increase, the Commission refused to allow the utility to submit summary data showing the effect of the proposed increases on its rate of return, and "all references to the effect of this increase on the company's overall financial condition were stricken."[135] Instead, the Commission "took the view that this increase should be considered solely on the basis of evidence reflecting the cost of these particular services."[136] As summarized by the appellate court:

> The resulting net increase in revenue to the utility was accomplished without any inquiry whatsoever into whether the increased revenues resulted in a rate of return

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[132] *Id.* at 230, 599 P.2d at 186.

[133] *Id.* at 230-31, 599 P.2d at 186-87. While the step increase methodology was upheld, the court also held that the Commission erred in relying solely on the return on common equity as the trigger for the increase, based on "the potential danger of tying rates to one factor over which APS exercises total control." *Id.* at 231, 559 P.2d at 187.

[134] *Scates v. Arizona Corp. Comm'n,* 118 Ariz. 531, 578 P.2d 612 (App. 1978).

[135] *Scates* at 533, 578 P.2d at 614.

[136] *Id.*

> greater or lesser than that established in the rate hearings some ten months before. All evidence bearing on the subject was expressly rejected.[137]

On appeal, the court held that the Commission lacked authority to increase rates without any consideration of the impact on the overall rate of return on the utility's rate base.[138] The court was careful to note, however, that the Commission may adjust rates without requiring a general rate case to be filed where exceptional circumstances exist:

> The Commission here . . . failed to make any examination whatsoever of the company's financial condition, and to make any determination of whether the increase would affect the utility's rate of return. There may well be exceptional situations in which the Commission may authorize partial rate increases without requiring entirely new submissions. We do not decide in this case, for example, whether the Commission could have referred to previous submissions with some updating or whether it could have accepted summary financial information.[139]

This discussion is consistent with the Arizona Supreme Court's discussion in *Arizona Community Action* and *Arizona Public Service* Co., which, as discussed above, clearly indicate that the Commission has considerable flexibility in complying with the requirements in Article 15 of the Arizona Constitution.

B. Addressing Each Adjustor Mechanism Proposed In The Settlement Agreement:

1. The LFCR.

Since the Company's last rate case decision in 2008, two significant events greatly influenced the Company's Application and the resulting Settlement Agreement. First, the Commission instituted rulemakings to consider the need for increased energy efficiency in Arizona, and to examine ways to protect customers from increasing utility bills. This resulted in the promulgation of the *Electric and Gas Energy Efficiency Standards* ("EE Rules"). These rules are designed to cause affected utilities to achieve energy savings through cost-Effective energy efficiency programs in order to ensure reliable electric service at reasonable rates and costs. As established in these rules, "energy efficiency" means the production or delivery of an equivalent level and quality of end-use electric service using

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[137] *Id.* at 534, 578 P.2d at 615.
[138] *Id.* at 537, 78 P.2d at 618.
[139] *Id.*

less energy, or the conservation of energy by end-use customers.[140] Energy efficiency is a type of DSM.[141] In Decision No. 71819, the Commission determined that the EE Rules were directly tied to its ratemaking authority:

> Requiring affected utilities to achieve energy savings through cost-effective energy efficiency programs is an essential part of the Commission's efforts to meet its constitutional obligation to "prescribe just and reasonable rates and charges to be made and collected . . . by public service corporations within the State for service rendered therein" because the amount of energy consumed by an affected utility's customers, and the pattern of peak usage of those customers, directly impacts the physical assets that an affected utility must have in place as well as the affected utility's operating expenses. Reducing the overall consumption of energy can reduce fuel costs, purchased power costs, new capacity costs, transmission costs, distribution costs, and adverse environmental impacts (such as water consumption and air emissions). Even reducing peak demand without reducing overall consumption can reduce fuel costs, purchased power costs, and new capacity costs because not as much plant or purchased power is needed at peak times to meet customers' needs... Thus, the rates that a utility is authorized to charge its customers are inextricably related to the amount of physical assets (such as generation plant facilities) used by the utility and the costs of service incurred by the utility (such as costs of purchasing power to meet peak load and the costs of the fuel sources used to generate electricity).[142]

Second, the Commission recognized that sales reductions resulting from energy efficiency programs will significantly impact a utility's ability to recover its Commission approved fixed costs, thereby creating utility disincentives to promoting energy efficiency and achieving the levels of energy savings required by the EE Rules. A series of workshops were held, which culminated in the adoption by the commission of the *Policy Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures* ("Policy Statement").[143] While the Commission expressed a preference for full revenue decoupling, the Policy Statement also recognized that other alternatives should be proposed as well. The Commission also stated that utilities may file a proposal for decoupling, or an alternative mechanism for addressing disincentives, in its next general rate case.[144]

The LFCR, as designed, is a mechanism narrowly tailored to collect distribution and transmission service costs that would have been recovered through usage lost to EE/DSM programs

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[140] A.A.C. R14-2-2401(17).
[141] Decision No. 71819 at 1, Docket No. RE-00000C-09-0427.
[142] *Id.* at 11- 12.
[143] Docket Nos. E-00000J-08-0314 and G-00000C-08-0314.
[144] *Id. Policy Statement* at 32 (docketed 12-19-2010).

and DG systems. In *Scates,* the court noted that when adjustors are initially adopted as part of the utility's rate structure in accordance with all statutory and constitutional requirements and, further, because they are designed to insure that, through the adoption of a set formula geared to a specific readily identifiable cost, the utility's profit or rate of return does not change.[145] The LFCR is designed to recover only a portion of narrowly defined lost revenues, that being transmission and distribution costs. Those lost revenues are part of the revenue requirement being determined in this rate case. TEP will not earn any return on the lost revenues during that lag. The recovery under the LFCR will not increase TEP's rate of return above that authorized in the rate case.

Further support for the LFCR can be found in *Residential Util. Consumer Office v. Arizona Corp. Comm'n.* There, the Commission attempted to establish a surcharge to allow Rio Verde Utilities, Inc. to recover expenses incurred for Central Arizona Project water expenses, outside of a rate case.[146] The court found that the Commission had exceeded its constitutional ratemaking authority by approving a surcharge to recover expenses without determining the fair value of the utility's property. In discussing automatic adjustment clauses, the court stated:

> Automatic adjustment clauses are designed to ensure that utilities maintain a relatively constant profit despite an increase in a specific cost anticipated by the adjustment clause. An automatic increase allows a utility to recoup cost increases by passing the costs onto the customer while at the same time maintaining the utility's net income. *Id.* The same is true in the converse situation, that of an automatic decrease. The decrease in cost is passed onto the customer without disturbing a utility's profit. In essence, an automatic adjustment clause is designed to offset increases or decreases, leaving the utility's ultimate net income unchanged. [147]

Unlike the adjustor at issue in *RUCO*, fair value has been determined and the adjustor will be established within a rate case. The Commission has approved similar mechanisms for APS and for TEP's sister company, UNS Gas.[148] Although the LFCR proposed for Southwest Gas differs in some aspects for the LFCR proposed in the Settlement Agreement, the Commission found that decoupling

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[145] *Scates*, 118 Ariz. 531, 578 P.2d 612.

[146] *Residential Util. Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001).

[147] *Id.* at 591-92, 20 P.3d 1169, 1172-173.

[148] Decision No. 73183, Docket No. E-01345A-11-0224; Decision No.73142, Docket No. G-04204A-11-0158.

and the proposed Southwest Gas LFCR "satisfy constitutional requirements because the mechanisms flow from a general rate case in which all costs have been determined to be just and reasonable, and [the] FVRB and FVROR will not fluctuate for purposes of determining future adjustments."[149].

The LFCR is also consistent with the Commission's Policy Statement. The Commission, in its Policy Statement, addressed a critical problem, the state's need for increased energy efficiency in the face of population growth and the corresponding increases in the demand for energy.[150] The Commission recognized, under the traditional ratemaking, utilities have not been incented to vigorously utilize demand-side management program to meet their resource needs. Utilities may struggle to recover their fixed costs through volumetric sales because of the pressure to achieve energy savings pursuant to Commission rule. TEP witness David Hutchens testified that TEP is unable to recover the fixed distribution and transmission costs that are embedded in its volumetric rates.[151] The Commission thus began considering alternate approaches it could adopt to spur the use of demand side programs, commencing workshops on decoupling. The ability to address resource issues, while providing utilities with a means to recover fixed costs with declining sales, falls within the Commission's ratemaking authority.

The LFCR mechanism comports with the jurisprudence of this state for the lawful establishment of an automatic adjustment clause. The LFCR will be established in a rate proceeding. In *Scates,* the court noted that when adjustors are initially adopted as part of the utility's rate structure in accordance with all statutory and constitutional requirements and, because they are designed to insure that, through the adoption of a set formula geared to a specific readily identifiable cost, the utility's profit or rate of return does not change.[152]

The Commission determined that it has the authority through its constitutional ratemaking authority to promulgate the EE rules along with the appropriate method of cost recovery. The LFCR falls within the Commission's ratemaking authority. The LFCR satisfies the *Arizona Community*

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[149] Decision No. 72723, Docket No. G-01551A-10-0458.
[150] Policy Statement at 1, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314.
[151] Hutchens S.A. Direct, Ex. TEP-2 at 14.
[152] *Scates*, 118 Ariz. 531, 578 P.2d 612.

Action and *Scates* requirements because it is an automatic adjustment mechanism that is being considered in a rate proceeding which includes a "fair value" analysis of the Company's utility plant.

2. Environmental Compliance Adjustor.

The ECA is a mechanism that will allow TEP to recover a portion of the significant costs required to meet environmental compliance standards imposed by federal or other governmental agencies between rate cases. A cost recovery mechanism designed for the extraordinary cost to comply with government mandates is not a new concept. In Decision No. 66440, the Commission recognized that, for water companies to comply with rules established by the United States EPA that required a significant reduction of the maximum contaminant levels ("MCL") for arsenic in potable water, the cost could be significant and have the potential to harm the financial integrity of some utilities. The Commission approved the Arsenic Cost Recovery Mechanism ("ACRM") which recovered capital costs and associated O&M costs related to the construction and operation of arsenic treatment plant.

In reviewing legality of the ACRM, the Commission, in a review of applicable case law, found that the courts have stated that "the Commission has discretion to consider matters subsequent to the test year, as long as the ratemaking method used by the Commission complies with the 'fair value' mandate of the Arizona Constitution" and that "it was in 'the public interest to have stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings."[153] The Commission concluded that the ACRM satisfied *Scates* and the Arizona Constitution because it was an automatic adjustment mechanism that was being adopted in a rate case that included a "fair value" finding and because the expenses eligible for recovery were narrowly defined.[154]

The Company will file detailed cost information, as detailed in the Plan of Administration, to support its request before there is recovery. Because those carrying costs are based on TEP's WACC approved in this rate case, TEP will not see any increase in its authorized rate of return. The resulting

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[153] Decision No. 66400, Docket No. W-01445A-00-0962 (*citing Arizona Corp. Comm'n v. Arizona Pub. Serv.*, 113 Ariz. 368, 555 P.2d 326 (1976).

[154] Decision No. 66400 at 19-20.

carrying costs are lower that TEP's authorized fair value rate of return because there is no fair value increment associated with the carrying cost under the ECA.

Further, the proposed ECA is also very similar to the mechanism that the Commission approved for APS in Decision No. 73183. This adjustor comports with the requirements of *Scates* and Article 15, section 14. The ECA as proposed satisfies the *Arizona Community Action* and *Scates* requirements because it is an automatic adjustment mechanism that is being considered in a rate proceeding which includes a "fair value" analysis of the Company's utility plant.

3. The Energy Efficiency Resource Plan and DSMS.

The EERP allows TEP to invest in cost-effective EE/DSM programs and recover those costs, including a return on its investment, but not a performance incentive, from customers through the Commission-approved DSMS over a five year period. Currently, TEP recovers EE/DSM program costs, including a performance incentive, from customers through the DSMS over a one year period and expenses the costs of implementing these programs in that same year. Under the EERP, customers will only pay for EE/DSM programs if TEP can show that its investments in those programs have provided quantifiable benefits in accordance with the performance metrics approved by the Commission. The recovery for these costs will flow through TEP's currently approved DSMS. As discussed above, the Commission determined that there was a need for energy efficiency and also determined that the appropriate method for recovery was the DSM surcharge. Effectively, the EERP is a new way to recover the costs of Commission-approved EE/DSM programs and related budgets.[155] The courts have acknowledged that subject to establishing rates on the fair value of a utility's property, the methods and manner of setting rates are within the Commission's discretion.

4. The PPFAC.

TEP's PPFAC was established by Decision No. 70628. The PPFAC is designed to pass through specifically defined fuel and purchased power costs. It is an adjustor that is contemplated by Arizona case law on the establishment of adjustors and falls within the Commission's ratemaking

[155] Olea S.A. Direct, Ex. S-14 at 18.

authority. This type of adjustor has been approved by the Commission in numerous previous rate cases for Arizona energy utilities.

C. Can An Adjustor Be Changed Outside A Rate Case?

During the hearing Judge Rodda posed an additional question of whether the Commission can change any of these adjustors established in this case. As discussed above, *Scates* found that in general, adjustors are set in a rate case, as part of a utility's rate structure.[156] The court in *Scates* acknowledged, however, that there may be "exceptional situations" where the Commission could authorize partial increases outside of a general rate case.[157] The court stated that it was not deciding "whether the Commission could have referred to previous submissions with some updating or whether it could have accepted summary financial information."[158]

Clearly, the Commission, under A.R.S. § 40-252, could reopen this case if it determines that something has gone awry with an adjustor approved in the case. However, this should not be construed as precluding the Commission from modifying any underlying policies that provide support for any adjustor approved. For example, if the Commission were to modify the EE Rules to reduce or eliminate some cost item, the adjustor, but not its basic structure, would be reduced or eliminated.

D. The Effect Of The Ex Parte Rule When A Docket Is Left Open.

During the hearing, Commissioner Brenda Burns posed the question of when obligations arise under the "ex parte rule" in the event a docket is left open. According to Arizona Administrative Code R14-3-113, Unauthorized Communications ("Ex Parte Rule"), the provisions of the rule apply from the time a contested matter is set for public hearing before the commission. In the event there is a Commission decision which leaves a docket open to address a specific issue, the Ex Parte Rule does not go into effect until the specific issue is set for a hearing.

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[156] *Scates* 118 Ariz. at 535, 578 P.2d at 616; see also *RUCO* 199 Ariz. at 591, 20 P.3d at 1172.
[157] *Id.* at 537, 578 P.2d at 618.
[158] *Id.* at 537, 578 P.2d at 618.

V. CONCLUSION.

It is Staff's belief that the terms of the Settlement Agreement are just, reasonable, fair and in the public interest as it, among other things, establishes just and reasonable rates for TEP customers; promotes the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons of TEP; resolves the issues arising from this docket; and, avoids unnecessary litigation expense and delay. For the reasons stated herein, Staff supports the Settlement Agreement as written and recommends its adoption by the Commission without amendment.

RESPECTFULLY SUBMITTED this 22nd day March, 2013.

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